

EU-US Coalition on Financial Regulation

The Transatlantic Dialogue in Financial Services: The Case for Regulatory Simplification and Trading Efficiency



The Industry Case for Priority Regulatory Action: Volume I



American Bankers Association Securities Association (ABASA)

Bankers' Association for Finance and Trade (BAFT)

British Bankers' Association (BBA)

Futures Industry Association (FIA)

Futures and Options Association (FOA)

Securities Industry Association (SIA)

***EU-US Coalition on Financial Regulation
The Transatlantic Dialogue in Financial Services:
The Industry Case for Priority Regulatory Action***

Volume I

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This abbreviated version of the Report "The Industry Case for Priority Regulatory Action" (Volume I) includes a number of cross-references to the relevant pages of the supporting "Comparative Legal and Regulatory Analysis" (Volume II), but it is intended to read as a stand-alone document. Both Volumes are available in PDF format from the websites of the Participating Associations.

Foreword

As the six sponsoring trade associations¹ of this Report, we welcome the increased priority that has now been given by governments and regulatory authorities in both the US and the EU to the transatlantic dialogue in financial services. In preparing this Report, we have focused on one particular but critically important market segment of what is a very diverse and substantive economic sector, namely, cross-border wholesale dealings in equities and equity derivatives.

We recognise that globalisation, the proliferation of trading platforms, product innovation, wider customer and market access and the ability of technology to cross national boundaries have all posed a major regulatory challenge for financial service regulatory authorities. Unfortunately and despite the commendable efforts of IOSCO and Basel to develop high level common standards and principles, regulatory authorities and their rules continue to be geographically based and governed by differentiated national laws. The result is a complex and costly meld of regulatory duplication and conflict which sits uneasily with the increasingly global nature of financial markets and services, undermines the intended benefit of harmonisation and generates unnecessary business costs for both the providers and consumers of financial services.

This Report is contained in two volumes. The first volume sets out the "business case" for priority regulatory action for establishing a more coherent framework of regulation for the carrying on of US/EU cross-border business. The second volume, compiled independently by the international law firm, Clifford Chance LLP, provides a comparative legal and regulatory analysis of US and EU (including France, Germany, Spain and the UK) authorisation, business conduct and other related rules.

Our motives in sponsoring this Report were the significant trading and commercial efficiencies that could accrue to all market participants from the establishment of an efficient and well-regulated transatlantic financial services marketplace. Moreover, improved trading efficiency will generate greater competition which, in turn, will result in lower costs for institutional and other customers of the financial services industry.

Capturing the costs of regulatory compliance is more an art than a science. Constant variables such as changing regulatory policy, market innovation and the continuing impact of new technologies mean that attempts at accurate measurement are hard to achieve. At a high level, it is clear that millions of pounds of expenditure on achieving regulatory compliance with overly prescriptive, complex, conflicting or overlapping requirements, can be taken out of the industry to the benefit of its customers.

¹ Please refer to Appendix III for a short description of each of the Participating Associations.

At the same time, we recognise that convergence (and the necessary consensus that must precede it) may take time to develop into a set of concrete proposals. Nevertheless, we believe that as the market and trading environment has changed, so must the way in which it is regulated. We particularly welcome therefore the various mechanisms that have been put in place to achieve the necessary change (and which are set out in paragraph 29 of this Report) - and it is a change that now can and must be taken forward. Moreover, the critically important economic and commercial objectives of facilitating innovation, enhancing efficiency and liberalising customer choice can only be attained if the process of change is taken forward on a genuinely consensual basis in which all the "stakeholders" in the process are not just consulted, but become an integrated part of the process and their views given full and proper consideration. To do anything else will be to achieve less.

As the six sponsoring trade associations of this Report, we would like to conclude this Foreword by recording our thanks to all those financial institutions and other organisations which provided input into the Report, notably Clifford Chance LLP in compiling Volume II, or who sponsored its production and, in this context, our particular thanks go to our co-sponsor, The Corporation of London.

American Bankers Association Securities Association (ABASA)

Bankers' Association for Finance and Trade (BAFT)

British Bankers' Association (BBA)

Futures Industry Association (FIA)

Futures and Options Association (FOA)

Securities Industry Association (SIA)

Preface by Co-Sponsor

The Corporation of London is delighted to co-sponsor this important piece of research because international financial centres have much to gain from reducing unhelpful regulatory tensions and duplication, and by promoting high level standards in the financial services industry on both sides of the Atlantic.

We have long been supportive of the case for a free marketplace governed by a coherent framework of harmonised rules and regulations. Previous research commissioned by the Corporation has focussed on potential efficiency savings in EU-US capital markets, on transatlantic comparisons of regulatory impact assessments, and on the strong linkages that exist between the financial centres of London and New York. We are very pleased, therefore, to continue supporting the development of a transatlantic industry agenda which has, at its heart, the need for regulatory simplification of financial services business.

The challenge of regulatory simplification is also one which the Corporation continues to promote within the EU. Our EU Advisory Group aided by our City Office in Brussels is pursuing pan-EU arguments for making the single market for financial services truly open and much more productive. As attention increasingly turns to EU-US relations this research will also assist our efforts to lobby for the creation of an open and efficient transatlantic market in financial services, so that investors on both sides of the Atlantic benefit from greater market choice and lower investment costs.

Michael Snyder, Chairman, Policy and Resources Committee, Corporation of London

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Executive Summary

1. Structure of the Report

1.1 This Report, which has been prepared by six EU and US industry associations² working in association with the international law firm, Clifford Chance LLP, and supported by the Corporation of London, is in two volumes.

1.2 Volume 1 of the Report comprises:

- an executive summary, including a summary of priority areas for regulatory action and proposed "next steps" in respect of the transatlantic wholesale equities/equity derivatives market; and
- a "business case" for priority regulatory action in respect of identified areas of unnecessary regulatory complexity and conflict which are obstructing the establishment of a cost-effective and commercially efficient transatlantic wholesale equities/equity derivatives marketplace.

1.3 Volume II of the Report consists of a comparative analysis of EU and US legislative and regulatory requirements (principally relating to the licensing of firms and business conduct rules) governing the carrying on of cross-border wholesale business in equities and equity derivatives.

2. *Motivation for writing the Report*

2.1 In determining upon the need for a Report of this nature, the six Participating Associations were motivated by a number of concerns, namely:

² The American Bankers Association Securities Association, the Bankers' Association for Finance and Trade, the British Bankers' Association, the Futures Industry Association, the Futures and Options Association and the Securities Industry Association. Please refer to Appendix III for a short description of each of the Participating Associations.

- the fact that regulatory change (aside from the evolution of high-level standards and principles) often involves little or no advance communication between regulators in different jurisdictions with the result that, notwithstanding that they may have often been driven by common public concerns and objectives, many rules are needlessly differentiated and the process merely serves to generate successive layers of regulation and add-on rules with no consequential reductions in "red tape". This need for regulatory cooperation has been recognised by Charlie McCreevy, the European Commissioner for Internal Market and Services, who has previously stated that: *"International cooperation in a globalised world is imperative if we are to create level playing fields; if we are to avoid unnecessary, burdensome and costly duplication, and if we are to deliver higher and consistent standards that build confidence in capital markets... Cooperation between legislators and supervisors urgently needs to catch up with the markets in the way they work together on a global scale. Increasing globalisation and integration have changed the business landscape for good. Hand in hand with this development, it is unavoidable that regulation in one jurisdiction spills over into others. We must therefore work together to minimise unnecessary regulatory duplication and legal friction. This is particularly important in transatlantic relations. We are still each other's most important trading partner. Almost all decisions taken by our regulators and supervisors affect the other side of the Atlantic almost as much as our own. We need to manage together these ripple effects to avoid tsunamis. Cooperate ex-ante, to avoid painful ex-post regulatory repairs"*³;
- continued regulatory conflict and duplication, far from enhancing investor protection or market integrity, serves only to drive up trading and investment costs for consumers and investors, undermine business and regulatory efficiency, reduce customer choice and confuse both providers and consumers of financial services as well as the regulatory authorities themselves. As recognised by Sharon Brown-Hruska, previous Acting Chairman of the US Commodity Futures Trading Commission ("CFTC"): *"It is time for regulators to catch up to the marketplace by removing undue barriers that limit the ability of a market participant or intermediary to conduct business based solely on the particular jurisdiction in which that person or firm finds themselves. Our task as regulators should be to foster the conditions that allow markets to perform seamlessly, and individuals and firms to execute their preferences globally and maintain their preferred relationships with service providers. If we do so, markets can compete with one another and innovate in order to provide the highest possible level of service to their customers at the lowest possible cost"*⁴;

³ Speech by Charlie McCreevy, European Commissioner for Internal Market and Services: "The integration of Europe's financial markets and international cooperation"; Concluding Remarks, Euro Conference; New York, 20 April 2005.

⁴ Speech by Acting Chairman Sharon Brown-Hruska: "Market Competition and Regulatory Cooperation: A New Dynamic in US-EU Financial Relations", Center for European Policy Studies, Brussels, 24 May 2005.

- the continuing mismatch between regulated business, which is conducted in a global marketplace, and its regulation, which is founded on geographical lines. As it was put by the Chairman of the UK Financial Services Authority ("FSA"), Sir Callum McCarthy: *"Most regulation is rooted in national legislation. But the business of large firms is increasingly complex and global. Regulators are rightly under pressure to remove duplicative or inconsistent regulatory requirements arising from firms having to deal with multiple regulators in the EU and worldwide"*⁵; and
 - the absence of a strong "business agenda" for priority regulatory action and the failure to give due place and recognition in real terms to the importance of maintaining product and services innovation, market access, customer choice and commercial efficiency.
- 2.2 The Participating Associations recognise that these concerns are of a general nature and will not necessarily apply in equal measure to all regulatory authorities.
- 2.3 Another motivating, significant and commercially important factor for this Report is the cost efficiencies that could be achieved for market participants (and ultimately all investors) in reducing unnecessary and duplicative regulations and rules in the transatlantic financial services market. Although this Report does not seek to provide a quantitative analysis of the transatlantic market, the following paragraphs help to emphasise the importance of the transatlantic sector to the global financial services market and, in turn, the considerable financial benefits that could be achieved by reducing existing transatlantic market inefficiencies.
- 2.4 The transatlantic financial services market is well known to be a major driver of the global market. However, data in a recent IMF Global Financial Stability report helps paint the picture of quite how important this market is. The IMF report calculated the sum of stock market capitalisation, debt securities and bank assets in the EU to be nearly \$47 trillion in 2003; whilst in the US the total was around \$41 trillion. Together they accounted for two-thirds of the world total.
- 2.5 The EU and the US' interdependence should also not be underestimated. For example, in 2003 the value of EU-US trade in goods and services was in excess of €550 (\$668) billion, 60% of US foreign direct investment was from the EU and 46 per cent of US investment abroad was in the EU, some €650 (\$789) billion.⁶ Total foreign assets of US corporations were valued at over \$5.2 (€4.3) trillion in 2000, of this roughly 58% (over \$3 (€2.5) trillion), were located in Europe. Conversely European corporations had assets of \$3.3 (€2.7) trillion in the US in 2000, just over two-thirds of the global total.⁷ This interdependence is also reflected in the financial services sector. Net purchases of long-term US domestic securities by European investors, for example,

⁵ "Europe's financial regulators must exploit existing ties": Sir Callum McCarthy, Chairman of the Financial Services Authority; Financial Times, 22 August 2005.

⁶ "Drifting Apart or Growing Together? The Primacy of the Transatlantic Economy"; Joseph P. Quinlan, Fellow; Center for Transatlantic Relations, Johns Hopkins University, 2003.

⁷ "Drifting Apart or Growing Together? The Primacy of the Transatlantic Economy"; Joseph P. Quinlan, Fellow; Center for Transatlantic Relations, Johns Hopkins University, 2003.

amounted to US\$364.882 billion (of a global total of \$916.653 billion) in 2004.⁸ Meanwhile, in 2003, US-based companies accounted for four out of the five top global brokers for international debt issuance⁹, four out of the five top global brokers for equity issuance¹⁰, the five largest global custodians¹¹ and the two main worldwide credit rating agencies.

- 2.6 Interested parties believe that a completely barrier free transatlantic capital market will unleash great economic potential - higher growth rates, more jobs and safer pensions in both the US and the EU¹². In December 2002, a study by Benn Steil¹³, a highly respected academic commentator on these matters, estimated that true integration of financial markets could lower trading costs on both sides of the Atlantic by 60%. Mr. Steil estimated (on a conservative model) that this would in turn lead to a 50% increase in US and European trading volumes and a 9% reduction in the cost of equity capital.

3. **Constraints on regulatory convergence**

- 3.1 The Participating Associations are aware of the statutory, political and public policy constraints that overlay the framing of financial services law and regulation, but it is their considered view that there is valuable work to be done at a technical level to progress regulatory convergence. It is also recognised that concepts of market integrity, market access and investor protection will differ between the US and the EU (and, internally, between the different regulatory authorities in the US and the EU). Nevertheless, there are consensual strands in international regulatory policy which should be capable of being developed into common definitions and rules. For example, market participants discern that most jurisdictions now draw some form of distinction between institutional or wholesale business and retail business, but the outworking of that regulatory policy is obstructed through a multiplicity of definitions as to what constitutes wholesale/retail business and/or wholesale/retail investors. Section 6 of Part A of Volume II presents an insight into the lack of uniform approach as to client definitions, even amongst EU Member States.

⁸ Chart CM-C; Net Purchases of Long-Term Domestic Securities by Foreigners, Selected Countries; US Treasury.

⁹ Source: Euromoney, 2003.

¹⁰ Source: Euromoney, 2003.

¹¹ Source: www.globalcustody.net, 2003.

¹² Charlie McCreevy, European Commissioner for Internal Market and Services: "The integration of Europe's financial markets and international cooperation"; Concluding Remarks, Euro Conference; New York, 20 April 2005.

¹³ "Building a Transatlantic Securities Market" by Benn Steil, published by the International Securities Market Association, Zurich, in cooperation with the Council on Foreign Relations, New York, December 2002.

4. **National fiscal policies**

- 4.1 The Participating Associations are also aware that taxation issues have a bearing on the detailed structure of arrangements in all forms of business activity connected with the development of the transatlantic wholesale equity/equity derivative markets. Taxation has been, and will remain, a key consideration for firms in determining methods of market access and organisational structures. However, the principal focus of this Report is on the cross-border regulatory framework and how such regulations affect the development of a true transatlantic equities/equity derivatives market. The Participating Associations consider that much valuable work can be done to enhance the transatlantic marketplace, without interested parties seeking to address matters of taxation.

5. **The business case for priority regulatory change**

- 5.1 The next part of this Report (the *business case for priority regulatory change*) is drawn from (a) a series of one-on-one interviews conducted by Clifford Chance LLP with executives within selected financial institutions undertaking cross-border transatlantic business; (b) a survey (see Appendix I) of the views of the core memberships of the Participating Associations (which, between them, include most of the world's leading financial institutions); and (c) a business-focused review of the comparative regulatory analysis to identify those regulatory differences which have the most significant impact on commercial efficiency.

6. **The comparative legal and regulatory analysis**

- 6.1 Volume II of this Report (the *comparative legal and regulatory analysis*), is based on a legal review conducted by the international law firm, Clifford Chance LLP, through its French, German, Spanish, UK and US offices, of EU legislative requirements (including proposed EU directives), Committee of European Securities Regulators ("**CESR**") standards and the related rules of selected Member States (i.e. France, Germany, Spain and the UK) and comparable US requirements, particularly the rules of the Securities Exchange Commission ("**SEC**") and the Commodity Futures Trading Commission ("**CFTC**"). The analysis does not cover business conducted with retail investors or prudential regulation, but it does address licensing and business conduct rules, financial promotion and solicitation, customer documentation, standards of execution, anti-money laundering requirements, market abuse, the handling of customer assets and the recognition of qualifications and licensing requirements for key employees.

7. **Cautious optimism**

7.1 Notwithstanding the controversy surrounding the adoption of legislation or regulatory requirements that have an extraterritorial impact (e.g. the Sarbanes-Oxley Act of 2002), and the continuing tendency for national governments to pursue their own regulatory agenda without engaging in adequate international consultation, the Participating Associations have approached this project with cautious optimism, noting particularly the recent agreements reached between CESR and each of the SEC and the CFTC. Both arrangements foreshadow greater regulatory cooperation in the area of rules development. The SEC-CESR dialogue announced in June 2004 looks to identify regulatory projects in the interests of facilitating converged, or at least compatible, ways of addressing action issues. The CESR-CFTC communiqué released on 31 March 2005 expressly recognises "*the increasing interest in elaborating efficient means of conducting transatlantic derivatives business and growing EU-US business relationships*". Both statements effectively summarise the motivation of the Participating Associations to produce this Report. To this end, the Participating Associations support their focus on: (i) enhanced transparency and clarity of regulatory requirements; (ii) simplified access or recognition procedures; and (iii) targeted consultation on cross-border issues. Growing political will to tackle these challenges is evidenced by recent remarks by both US Treasury Secretary John Snow and Charlie McCreevy, the European Commissioner for Internal Market and Services, as to the need to add dynamism to the liberalisation of the transatlantic financial market: "*We know that financial liberalisation is one of the most critical drivers of our countries' economic vitality. Our transatlantic relationship is the nexus for the lion's share of the world's financial market participation, so we have a unique and shared responsibility to ensure the efficient performance of markets and smooth adjustments in global accounts.... The gains from US-European cooperation on growth and financial markets are potentially enormous. The US and Europe, as the world's two largest economies, must seize this opportunity and lead*"¹⁴.

8. **Framing a worthwhile dialogue**

8.1 The Participating Associations see this Report as an essential private sector contribution (supported by a key public interest administrative body, in the form of the Corporation of London) to the case for regulatory simplification, but if the dialogue is to have an outcome that is tangible and of real benefit to financial service providers and their customers, the process will require a more open approach to regulatory change, for example:

- a willingness to "give and take" on the detail of rules, subject to maintaining acceptable standards of investor protection and market integrity;
- a readiness to de-prioritise the "ownership" of a particular rule and focus on what is necessary, deliverable, effective and cost-efficient;

¹⁴ Speech by US Treasury Secretary John Snow: "Remarks at Conclusion of Europe Trip"; Amerika Haus, Frankfurt, 16 June 2005.

- the development of a common EU/US approach to "principles of good regulation" or "better regulation" which can stand behind the process of onward consensual regulatory development, help foster EU/US regulatory coherence in the future and results in "*[r]egulation that opens up markets - where they need to be opened up, that breaks down barriers - where they need to be broken down, that enhances competition - when it needs to be enhanced, that delivers for business and the consumer the benefits of efficiency and scale - when they can be delivered*"¹⁵. As such, regulation should not stifle innovation. Indeed, "*[i]t is economic freedom that lets markets best play their role: to experiment and to come up with new ideas, better products and more streamlined processes. This is how new companies are founded and new jobs are created. How economies remain dynamic, competitive and open to the future. Legislation has to help, not hinder, this process - working with the ebbs and flows of markets*"¹⁶; and
- a readiness to take the work forward on a consensual basis with consumers, financial service providers and regulatory authorities (who are all critically important "stakeholders" in the process) and which goes beyond the mere function of periodic consultation.

9. Change and convergence will take time

9.1 It is equally important that the financial services industry also adopts a "give and take" approach to the process of change and recognises that progress is likely to be piecemeal and protracted for the following reasons:

- regulatory change inevitably must be sensitive to firms' costs in changing systems and documentation and training staff (i.e. it should focus on the simplification and reduction in regulatory cost (which should benefit both domestic and international firms));
- the transatlantic dialogue takes place against a background of fundamental regulatory change in the EU, which is placing severe resource constraints on EU and Member State government departments and regulatory authorities (as well as their regulated firms), thereby increasing resistance to additional legislation in this field (particularly where the adjustment costs associated with transatlantic convergence must also be borne by smaller or only locally active financial institutions which are unlikely to receive the same cross-border benefits as more internationally focussed institutions). It may also be the case that there is resistance to legislative change in this area in the US, as a result of the US law-making process for which the transposition of internationally accepted standards does not constitute the primary source of national securities law;

¹⁵ Charlie McCreevy, European Commissioner for Internal Market and Services: "Regulation – Right and Wrong"; Annual Conference on Financial Services Action Plan, Dublin Castle, Dublin, 5 April 2005.

¹⁶ Charlie McCreevy, European Commissioner for Internal Market and Services; "The Commission's Financial Services Policy 2005-2010 - Exchange of Views on Financial Services Policy 2005-2010"; Brussels, 18 July 2005.

- public policy may constrain change and demand rules' equivalence, making regulatory recognition difficult to deliver in certain areas (although this is most likely to be prevalent where retail investors are concerned);
- overarching statutory principles and obligations will restrict the capacity to change rules or delay change in certain areas (although legislative change should not be regarded as a "bridge too far"); and
- convergence to a single standard should result in lower costs - complying with one standard (even if it might in some respects be tougher than what predated it) should be less expensive than complying with a range of incrementally different requirements.

9.2 Regulatory convergence is a critically important pre-requisite to achieving improved international regulatory coherence. However, it may not always result in the adoption of identical rules. Given that the degree of convergence is as much as can reasonably be achieved in the context of a particular requirement and without undermining their jurisdictional regulatory sovereignty, regulatory authorities on both sides of the Atlantic should be open to the possibility of being more flexible in taking account of each other's regulatory differences, where they deliver equivalent outcomes. Such an approach has the added advantage of reducing the cost and burden of further regulatory change for those domestic regulated firms for whom there will be little commensurate benefit because they will not be undertaking transatlantic business.

10. **Future engagement**

10.1 The Participating Associations are convinced of the necessity for a better quality of forward-looking dialogue between financial institutions and their regulators. They also believe that there is widespread recognition of the need to vitalise such a dialogue in the context of the transatlantic marketplace in financial services. The Participating Associations see this Report as a worthwhile contribution by the private sector to engaging with the public sector in looking to the future shape of regulation. The Participating Associations look forward with anticipation to engaging with regulators to facilitate the kind of change recommended in the Report.

EU-US Coalition on Financial Regulation

Summary of priority areas for regulatory action

These Key Points are set out in order of priority for attention by regulators and market participants

Public regulatory authorities are urged to work in association with private sector industry bodies and market participants in order to establish a more coherent regulatory framework for the regulation of the transatlantic wholesale equities/equity derivatives market, in particular, to:

1. Formulate and agree a common set of client/customer/counterparty definitions¹⁷ for:
 - (a) classifying customers;
 - (b) soliciting customers;
 - (c) documenting customer accounts/transactions; and
 - (d) according different levels of regulatory protection to each (simplified) category of customer.
- 2.1. Formulate and agree a common set of Know Your Customer (KYC) and risk-based Anti-Money Laundering (AML) standards and requirements in respect of each of the client/customer/counterparty definitions formulated and agreed in Key Point 1¹⁸.
- 2.2. If Key Point 1 cannot be actioned within a realistically acceptable timescale, then Key Point 2.1 should be pursued independently of Key Point 1 in order to create a common set of KYC and AML standards and requirements. There should, in addition, be a common standard of regulatory monitoring/supervision and enforcement in this area.
3. Establish a programme to identify and simplify key areas of regulation in the context of equities and equity derivatives business (and, as relevant, other services and products) including, for example:

¹⁷ For further information on client/customer/counterparty definitions, please see paragraphs 41 and 47 to 52 of this Report.

¹⁸ For further information on AML standards, please see paragraphs 66 to 70 of this Report.

- (a) best execution standards
 - (b) treatment of client assets
 - (c) allocation procedures;
 - (d) research distribution rules¹⁹; and
 - (e) rules as to transaction documentation.
4. Establish a common core of regulatory requirements and associated information-sharing obligations of regulatory authorities to remove avoidable duplication on firms²⁰.
 5. Create a standard form of Regulatory Impact Assessment/cost-benefit analysis²¹ and a standard methodology for conducting such an Assessment/analysis which will ensure delivery of a commercially efficient transatlantic marketplace. This implies a common policy which recognises the value and promotes the use of such a standardised methodology in both the US and the EU.
 6. Formulate and agree a common set of examination and registration requirements for those countries that operate licensing regimes or other forms of competence standards for individuals active in equities and equity derivatives markets²².
 7. It should be possible for the "product" elements of individual registration requirements to count towards demonstration of competency across all jurisdictions. If all jurisdictions adopted a modular approach to registration requirements, then individuals would only need to take additional specific regulatory modules for the various jurisdictions in which they do business.

¹⁹ For further information on research distribution, please see paragraphs 58 to 61 of this Report.

²⁰ For further information on regulatory collaboration, please see paragraphs 27 to 32 of this Report.

²¹ For further information on cost-benefit analyses, please see paragraphs 38 and 39 of this Report.

²² For further information on individual registration requirements and, in particular, the commendable efforts of the New York Stock Exchange, the US National Association of Securities Dealers and the UK Securities and Investment Institute in this regard, please see paragraphs 53 to 57 of this Report.

8. Consider the current lack of a single framework of access rights to EU Member States by firms from "third countries", such as the US, and to formulate and agree a single framework of EU access rights for firms based in well regulated "third countries"²³.
9. Formulate and agree a common set of standards and requirements relating to:
 - (a) outsourcing arrangements;
 - (b) outsourcing to facilities in foreign jurisdictions ("foreign" in this context meaning countries other than the US or EU Member States)²⁴.
10. Establish a common set of requirements for firms for clearing foreign exchanges on a remote basis.
11. Negotiate and agree a set of principles of good regulation that may be held in common by US and EU regulatory authorities.

²³ For further information on third country access, please see paragraphs 12 to 26 of this Report.

²⁴ For further information on outsourcing, please see paragraph 25 of this Report.

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The Transatlantic Industry Case for Priority Regulatory Action

11. The Participating Associations' findings in this part of the Report address the regulatory requirements which govern the carrying on of wholesale and institutional business in relation to secondary sales and trading of equities and broking and dealing in equity-related futures and options contracts on exchanges and, including their origination and customisation, over-the-counter equity derivatives which, in the view of market participants, merit priority review in the interests of market and trading efficiency. Many of the findings (and the questions posed by them) will be relevant to broking and dealing activities in other asset classes such as, for example, fixed income and foreign exchange, reflecting a trend towards uniformity of regulation in relation to products, services and markets in different asset classes.

Two fortresses in search of a causeway

12. The existence of a transatlantic marketplace in equities and equity derivatives is in spite, rather than because, of the regulatory frameworks on either side of the Atlantic. "Fortress Europe" is a tag line that has been attached to the establishment of a single European market by market participants in some "third countries" for nearly two decades. Critics of the 1992 Single Market Programme felt that the efforts to create harmonised financial services laws within the European Economic Area (EEA) (comprising the EU Member States and a number of other countries that have agreed to be bound by the same rules, but do not have a say in their making) as a conscious attempt to establish a protectionist wall against the inflow of business from third countries.
13. In fact, the drive to create a single European market in financial services had to be inwardly focused if it was to achieve the end product of converging the regulatory frameworks of 15 (now 25) different national systems governed by a variety of different jurisdictional and legal requirements. The process of EU regulatory change could have been taken forward on a more consensual basis with critically important third countries such as the US, but that would have delayed progress to the point at which the project would have lost all momentum and credibility. In the event, the prospect of having greater uniformity of content in EU regulation should facilitate rather than impair the prospects of a successful outcome to the current and continuing EU/US regulatory dialogue. Indeed, in theory at least, the US should only have to consider avoiding regulatory conflict with one co-ordinated EU regulatory position rather than with 25 separate and distinct EU Member State regulatory positions.
14. Whilst the EU's Financial Services Action Plan, coupled with the Lamfalussy process of rule-making, raises the prospect of greater uniformity of EU securities regulation, there are reservations about implementation and enforcement standards, the quality of day-to-day regulation and variables in access rights within individual EU Member States. Interestingly such reservations are being expressed on both sides of the Atlantic. Charlie McCreevy, European Commissioner for Internal Market and Services, recognises that the objectives of the Financial Services Action Plan are yet to be fully achieved: "*Day-to-day application of rules needs to be assured in a coherent manner. Yet, supervisory powers differ strongly between Member States. As a result, there can be*

*as many supervisory practices as there are supervisors in the Union, and presently there are 52! No doubt this causes additional regulatory burdens for financial institutions and leaves room for regulatory arbitrage particularly as the number of systemic cross-border financial institutions is increasing*²⁵. However, it is the view of US Treasury Secretary John Snow that the effects of such divergence are not limited to constraining the development of the EU financial services market, but also hamper transatlantic developments: *"If 25 different supervisors implement directives 25 different ways, the promise of a more integrated EU financial market will not be realised and it will be hard for the US and the EU to achieve convergence"*²⁶.

15. An example of this lack of uniformity amongst EU Member States, despite an apparent common basis, is the extent to which non-EU firms may conduct cross-border equities/equity derivatives business with institutional investors. For example, whilst access to UK institutional investors is fairly straightforward for US firms, the position in Spain is far more onerous: a US firm will be required to obtain a Spanish investment firm licence, which in practice will involve the establishment of a branch or subsidiary in Spain. This diversity of approach amongst EU Member States necessarily impedes the ability of US firms to conduct equities/equity derivatives business on a pan-European basis.
16. As for "Fortress US", some European commentators have complained that the US has its own market access barriers and that the confusion generated in the EU by the exercise of national regulatory discretion by EU Member States is mirrored with regard to certain financial service markets and activities by a similar framework of discretion exercised by the US states. For example, securities offerings to residents in each US state are governed by state law, which varies from state to state, in addition to federal law. In most cases, this plays out as a concern in relation to retail investors and, whilst a material consideration at a technical level, is less politically potent when considering marketing to, and broking for, institutional clients in a particular state.
17. Although the SEC's regulation of broker dealers and the CFTC's regulation of futures commission merchants are carried out on a country-wide basis under federal statutes, there are two fundamentally different regulatory approaches to granting US market access to non-US institutions as between the SEC and the CFTC. For example, the SEC, in Rule 15a-6, has a highly nuanced and sophisticated set of restrictions and permissions that define the gateways through which unregistered (i.e. unregistered with the SEC) foreign-based businesses may conduct business with a range of institutional investors and professional market participants. The CFTC, on the other hand, has developed, through its Part 30 rules, a regime that is founded on the unilateral recognition of the rules of other countries where, substantiated by a comparative regulatory analysis, they are deemed to be broadly equivalent to those applicable to US institutions in the US, with any significant regulatory differences (usually driven by national notions of public policy) being addressed by way of compliance with "add-on" US rules.

²⁵ Speech by Charlie McCreevy, European Commissioner for Internal Market and Services: "Regulatory and supervisory challenges of financial integration"; Lamfalussy London Summer Dinner, London, 27 June 2005.

²⁶ Speech by US Treasury Secretary John Snow: "US-EU Cooperation for Growth"; Center for European Policy Studies, Brussels, 14 June 2005.

Licensing Arrangements in the EU and the US²⁷

18. Global financial institutions active in equities and equity derivatives may be global in terms of their business activities, but they are certainly not single legal entities bearing a single licence. The current position is that licensing arrangements and the jurisdictional conditions that attach to licences militate severely against running transatlantic business through one legal entity. That said, even if steps were introduced to simplify the current licensing arrangements, differences in taxation may still outweigh the benefits of establishing a single entity. Nevertheless, regulatory impediments to commercial efficiency, including the establishment of such a single entity, which cannot be justified on acceptable grounds of investor protection, systemic risk concerns or market integrity, look increasingly anachronistic in the global marketplace.
19. The reasons why global financial institutions (aside from the issue of taxation) set up more than one entity to conduct institutional business in the EU and US equity and equity derivative markets vary as between the EU and the US.
20. In the EU, the Investment Services Directive (and the superceding Markets in Financial Instruments Directive ("**MiFID**")) requires a business that wishes to benefit from the single EU licence (the "**passport**") to be incorporated in an EU/EEA Member State. Such an entity can be owned by non EU/EEA interests, but the real point is that the passport may only be granted to a business that is legally established within the EU/EEA. Branches and representative offices of non-EU/EEA financial institutions may be established in the EU/EEA, but such offices cannot benefit from passporting rights. The same kind of restriction as to domestic legal incorporation does not apply in the US, given the absence of the need for passporting. It is open to non-US businesses to establish branches in the US and seek SEC broker-dealer registration or CFTC futures commission merchant registration.
21. However, an entity registered with the SEC in the US will automatically subject all its branches that are not based in the US to SEC jurisdiction and oversight, including on-site SEC visits. The assertion of jurisdiction by the SEC over books and records held in non-US locations is understandable and is also in line with the approach of other regulators based outside the US. However, the assertion of full jurisdiction by the SEC, is perceived to be far more onerous than the position adopted by EU regulators.
22. In addition to the above, there is a product jurisdictional split between the SEC and the CFTC whereby equities and equity options fall within the SEC's regulatory mandate, but certain equity derivatives such as futures on individual equities and on narrow-based stock indices are the shared preserve of the SEC and the CFTC. Futures on broad-based stock indices, meanwhile, are subject to the CFTC's exclusive jurisdiction. The apotheosis of this split jurisdiction has been seen recently with the introduction of stock futures contracts on US exchanges. Whilst the contracts have not been a great commercial

²⁷ For a further legal analysis of EU/US licensing requirements, please see section 8 of Part A of Volume II.

success, the legal and regulatory infrastructure that was required to bridge the jurisdictional split between the SEC and the CFTC took up substantial amounts of the time of regulators and interested industry participants.

23. The combination of the US and EU positions as regards the access of US firms to EU financial markets can severely curtail US firms' global platform aspirations. In the words of one market participant: "*The SEC gives us no encouragement to take our broker-dealer to Europe. And Europe provides no welcome in terms of the passport were we to get there. So we end up operating our business through separate entities on each side of the Atlantic*". For business to be done from the EU to the US or vice versa, the two legal entities must often interact closely. How closely will be illustrated shortly.

A US/non-US split

24. Global financial institutions have, broadly speaking, developed a split in their business. Most US business is carried out in the appropriate US vehicle, taking account of the product alignments of the different US regulators. EU business is done in an entity based in the EU or EEA that benefits from the EU/EEA passport. Although a quantitative analysis of business flows has not been within the terms of reference for this Report, a number of market participants have observed that they tend to do international business through an EU-based entity rather than through the US regulated entity, largely for time zone reasons.
25. Regulators, largely on a national basis, are now developing policies and/or rules relating to the material outsourcing of functions undertaken within financial institutions. Regulators ought to agree a common approach to the regulation of outsourcing, including extraterritorial outsourcing where the possibility of complex jurisdictional conflicts is plain to see.

Licensing: where to go from here?

26. Is it worth trying to untie this Gordian Knot? If a regime could be formulated that recognised that out of country branches of a licensed institution could be regulated on a day-to-day basis by the regulator of the country in which they were located, it would be possible to conceive of a one entity approach rather than different entities from each side of the Atlantic. Such an approach would compel regulatory authorities to face up to the reality of their overlapping legal jurisdictions and consider the utility of their current arrangements for surveillance and examination. Market participants sense that mutual confidence would need to be built among regulators to allow developments of this nature to gain credibility and some momentum. It would appear that such moves have already found support on a political level: "*The goal must be mutual recognition of equivalence. You can also call it the home-country principle. If you agree to accept each others system as equivalent then duplicative requirements disappear. You can then operate in the other country under the rules of your home*

country. I think we should find more areas in our transatlantic relation where we can apply this principle"²⁸. Arguably, however, mutual recognition requires a healthy degree of rules' convergence before it can be meaningfully effected by regulatory authorities in different jurisdictions.

Regulatory collaboration

27. US and EU regulatory agencies have been active for several years in agreeing Memoranda of Understanding (“MOU”). These instruments are intended to facilitate, subject to local legal constraints, information-sharing between regulators in different countries. The information shared could relate to enforcement cases or comprise market information or cover prudential concerns or market integrity issues or consist of more mundane, but important, information such as on rules' changes. It is probably time for MOUs to be revisited. For instance, not every regulatory authority has a MOU with either the SEC or the CFTC in the US and the accession of ten new Member States to the EU in May 2004 means that the SEC and CFTC are confronted with 25 Member States instead of 15 (plus the EEA countries that are not EU Member States). The next generation of MOUs could usefully address:
- (a) the trend in many financial institutions to place back and middle office functions on an enterprise-wide basis into a single location (not necessarily within the EU or US) with a disaster recovery plan; and
 - (b) the adoption of multi-regulator surveillance visits to registered firms.
28. A common complaint is that genuine coordination is rare and the burden of recycling information, often tailored to the specific preference of an individual regulator, is time consuming and expensive. On the other hand, the failure to establish a proper and workable framework of information-sharing means that regulated institutions still have multiple reporting requirements, often required to be submitted in different formats but covering the same information, to a variety of regulatory authorities – a major administrative cost that could be avoided through a structured and properly resourced information-sharing programme between regulators.

²⁸ Speech by Charlie McCreevy, European Commissioner for Internal Market and Services: "The integration of Europe's financial markets and international cooperation"; Concluding Remarks, Euro Conference; New York, 20 April 2005.

29. In recent years a number of initiatives have been launched with a view to transatlantic regulatory collaboration:
- (a) The SEC and CESR dialogue which aims to (i) identify emerging risks in the US and EU securities market for the purpose of improving the ability to address potential regulatory problems at an early stage; and (ii) engage in early discussion of potential regulatory projects in the interest of facilitating converged, or at least compatible, ways of addressing common issues;
 - (b) The CESR-CFTC communiqué which focuses on: (i) enhanced transparency and clarity of regulatory requirements; (ii) simplified access or recognition procedures; and (iii) targeted consultation on cross-border issues;
 - (c) The Transatlantic Business Dialogue between leading transatlantic companies whose objective is to help establish a barrier free transatlantic market which will serve as a catalyst for global trade liberalisation and prosperity;
 - (d) The Transatlantic (EU-US) Regulatory Cooperation Dialogue between the EU and the US which seeks to (i) improve the bilateral dialogue between US and EU regulators; and (ii) ensure effective access to the regulatory procedures of public authorities by private interests and government authorities on both sides; and
 - (e) The EU-US Financial Markets Regulatory Dialogue between EU and US regulatory authorities which aims to (i) diffuse difficulties arising from conflicting approaches to financial regulation; (ii) minimise any unintended extraterritorial consequences of regulatory action; (iii) foster mutual understanding of respective regulatory systems and promote a process of regulatory convergence on "best of breed" regulation; and (iv) identify specific situations where "exemptive relief" could be provided from the application of certain elements of the regulatory regime of the host jurisdiction.
30. The importance attached by the European Commission and the European Central Bank to facilitating supervisory convergence is also both timely and welcome. Jean-Claude Trichet, President of the European Central Bank, recently expressed support for supervisory convergence based on the current Lamfalussy arrangements.²⁹ According to M. Trichet, the Level 3 Committees³⁰ have to deliver policies that encourage supervisory convergence. In addition, independent regulatory authorities in EU Member States must comply with both the binding and non-binding policies and conclusions determined

²⁹ Jean-Claude Trichet, President, European Central Bank: report by European Commission of M. Trichet's comments at the European Commission's "Exchange of Views" Financial Services Policy 2005-2010, Brussels, 18 July 2005.

³⁰ Committee of European Banking Supervisors (CEBS), Committee of European Securities Regulators (CESR), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

by the Level 3 Committees. This is an important point. Even where transposition of EU directives appears to have been done in a substantially similar manner by different EU Member States, the anecdotal evidence heard all too often from within financial institutions is that interpretation of rules varies significantly as between EU regulators and sometimes within a particular regulatory authority. The need for regulatory collaboration is now recognised by regulators themselves. In a recent commentary in the Financial Times, Sir Callum McCarthy, the Chairman of the FSA, noted that, "*[i]t is essential that European directives are implemented in a timely and reasonably uniform way across Member States. Without this, firms will continue to face a diversity of regulatory requirements. But effective implementation is only part of the story. Regulators must also learn to collaborate more intelligently than in the past in dealing with international firms. This means, for example, sharing information rather than acquiring it independently by separate processes, undertaking joint work and placing more reliance on one another, There is scope for doing much more without new legislation and regulators need to explore what is feasible to the maximum extent*"³¹.

31. Recent EU developments, such as the Market Abuse Directive ("**MAD**") and MiFID, have recognised the importance of information-sharing between national regulators and CESR is currently developing procedures and structures to facilitate this (as, for example, set out in the Draft Commission Regulation on reporting transactions in financial instruments (ESC/7/2005 - rev2 13/05/05)). The establishment of CESR-Fin in the context of accounting standards and of CESR-Pol in the context of enforcement matters appear to be sensible initiatives to facilitate coherent implementation, interpretation and enforcement of pan-EU regulatory requirements.
32. One way in which practical meaning can be given to the philosophy of supervisory convergence is for regulators, and those to whom they are politically accountable, to take seriously the pleas of financial institutions in relation to reporting requirements, surveillance visits and inspection programmes. No one doubts their necessity but a fundamental effort to examine current practices with a view to making these aspects of regulation much more efficient is a contribution that needs to be made in order to take unnecessary cost out of the activity of regulatory compliance.
33. It is to be hoped that the above initiatives continue to exert influence and pressure on those with the mandate to facilitate transatlantic regulatory convergence/compatibility.

By issuing this Report, the Participating Associations seek to add their support to the above initiatives, whilst also providing the essential "business case" for priority regulatory action in respect of identified areas of unnecessary regulatory complexity and conflict which are currently obstructing the establishment of a cost-effective and commercially efficient transatlantic marketplace.

³¹ "Europe's financial regulators must exploit existing ties": Sir Callum McCarthy, Chairman of the Financial Services Authority; Financial Times, 22 August 2005.

Jurisdictional statements by regulators³²

34. A longstanding feature of US regulation (unlike that in the EU) has been the use of no-action letters by both the SEC and CFTC for a variety of purposes and in relation to a range of topics. They provide comfort to market participants in situations where either the law or the interpretation of the law or particular regulations may be open to argument in terms of how a relevant regulatory agency views matters. There are a number of no-action letters issued by each of the SEC and CFTC in relation to stock exchanges and derivatives exchanges located outside the US. These letters generally address the ability of market participants to sell to a range of institutional investors in the US either non-US securities or derivatives contracts that are made available for trading on specified non-US exchanges. In some cases, they prescribe particular forms of documentation to be used by market participants in soliciting business and opening customer accounts used in relation to dealings in non-US instruments.
35. No-action letters address specific points of interpretation that industry participants raise with the SEC or the CFTC. With the passage of time and changing business patterns, no-action letters are repeatedly scrutinised by market participants and their professional advisers in order to ascertain whether they are applicable in new situations or whether points are worthy of further clarification (or requests for clarification). In taking soundings from market participants for this Report, Clifford Chance LLP received indications of matters that some industry participants may regard as worthy of clarification at some point in the future.
36. No-action letters (or similar) are barely used in EU Member States. Some industry participants would like to see greater use of such techniques for resolving queries or ambiguities. As more aspects of the business (from front office to back office) are conducted on a cross-border basis, the need for jurisdictional and territorial interpretations by regulators increases.
37. Whilst resolving this kind of misunderstanding or ambiguity should be achievable in the short term, it is a good example of the need for regulators, when making new rules or reviewing existing rules or determining whether a rule is as useful as was originally expected, to take full and proper account of the commercial and market realities of global technological platforms and global business.

³² For a further legal analysis on the use of no-action letters in the US see section 2.3 of Part A of Volume II and section 2 and section 5 of Part B of Volume II.
For a further legal analysis on the use of no-action letters in Spain see section 2.3 of Part A of Volume II.

The benefits of Regulatory Impact Assessment

38. The benefits of regulatory impact assessment (or cost benefit analysis as it is better known in the US) are now a constant theme of discussion. The six Participating Associations are enthusiastic proponents of the principle of regulatory impact assessment or cost benefit analysis. They consider that it should be an immutable principle that such assessments are carried out on new rules and that existing rules are subject to periodic review, using these kinds of evaluation, including a comparison in terms of performance and cost with rules aimed at similar objectives in other jurisdictions. Giving appropriate weight to the transatlantic marketplace when determining new rules, or amendments to existing rules, would constitute a major step forward by regulators, policy makers and legislators towards their efficiency and accessibility.
39. Regulatory Impact Assessments (RIAs) are still an emerging discipline. Two papers produced by Graham Mather and Frank Vibert of the European Policy Forum, working in conjunction with the Corporation of London, amply demonstrate this.³³ The work of the European Policy Forum illustrates the patchwork quilt nature of what exists today. The need to institutionalise a consistent pattern of RIAs is readily apparent. Meaningful engagement with the RIA process by those charged with regulatory policymaking is essential and proper accountability for engaging with the substance of what a robust RIA requires is needed too. RIAs clearly have application in many areas other than financial services. However, they must be properly embraced by regulators of financial services. There are promising signs that this is happening, but these are early days. In addition, there is substantial risk that different forms of RIA might emerge, leading to material differences of practice and outcome. If impact analysis is to be a constructive addition to current policymaking processes, the benefits of a standardised approach cannot be over-estimated. In addition, appreciating the extraterritorial effects of any policy which is proposed is an essential component in the context of achieving regulatory convergence among different jurisdictions.

³³ “Reducing the Regulatory Burden: The Arrival of Meaningful Regulatory Impact Analysis”; European Policy Forum, Corporation of London, City Research Series No. 2, July 2004 and “Rebalancing UK and European Regulation”; European Policy Forum, Corporation of London, City Research Series No. 5, April 2005.

Pitching for business

40. Wholesale financial institutions vie with one another daily to win new business from new clients or new business from repeat clients on a global basis, yet the legal and regulatory background to this competitive activity is complex, expensive and founded largely on national boundaries.
41. The multiple definitions of customer, client and counterparty add unnecessary complexity to defining who may be approached in respect of the sale of a particular product. The split between equities and equity derivatives becomes quite prominent in this context. Some market participants have commented on a lack of clarity as to the solicitation rules when offering non-US equities and non-US exchange-traded futures and options contracts to US qualified institutional investors ("QIBs"). This particular topic has prompted a range of views to emerge and merits review with the objective of eliminating uncertainty.
42. SEC Rule 15a-6 is universally well known and is probably the most prominent rule in the transatlantic marketplace. Broker dealers that are not SEC registered have to comply with the restrictions and exemptions set out in this rule, if they are lawfully to offer securities (non-US securities) to institutional investors and/or SEC registered broker dealers. Although comprehensive in providing a measure of legal and regulatory certainty, the exemptions in Rule 15a-6 are regarded as complex and difficult to interpret and, in the view of some market participants, are sufficient to deter them from undertaking relevant business in the US. Others question their continued utility value.
43. The CFTC regime for solicitation is very different from the SEC regime. It permits a measure of direct access to US clients by non-US firms offering non-US futures (and some types of options) that is based on recognition of comparable home state rules (albeit conditional upon compliance with a number of "top-up" CFTC regulatory requirements). However, this is an approach that was initiated some time before the European single market had grown in stature and is based largely on bilateral relationships between the CFTC and national regulators in the EU and elsewhere.
44. The picture across the EU could not be more different. There is no uniform treatment in the EU of non-EU businesses seeking to solicit securities or derivatives business from institutional investors based in the EU. In some states, the conduct of business from the US does not trigger a local licensing requirement. In other states, the position as to licensing is uncertain. In others yet, a licence is required and, in some of those countries, that licence can be fairly easily obtained, whereas in others, intermediation through an EU licensed intermediary may provide a solution. In some Member States, however, intermediation is not an accepted solution³⁴.

³⁴ Please refer to Appendix II for a summary analysis of cross-border EU licensing issues and a more detailed description of intermediation structures. Please also refer to section 8 of Part A of Volume II for a more detailed legal analysis.

45. The six Participating Associations consider that this mix of national arrangements in the EU should be a key target for harmonisation. If the single market is to be the success that EU leaders wish, it must be a market that not only maintains a coherent internal focus for those businesses that possess a single market licence but, it must also be a marketplace that presents a coherent and consistent set of entry arrangements to businesses located outside the EU/EEA. At least Rule 15a-6, however burdensome, offers a single access regime in relation to those products that fall within the jurisdiction of the SEC.
46. The six Participating Associations would urge the European Commission to prioritise the need for greater coherence in this area in terms of implementing, in an even-handed way, the authorisation requirements set out in EU directives (which would be in line with the priority being given to even-handed implementation of pan-EU requirements as a post-Financial Services Action Plan objective).

Definitions of customer/client/counterparty³⁵

47. Market participants are unable to agree on how many definitions there are of customer, client and counterparty. Given the broad spread of this type of definition in EU Member States, this is understandable, but it soon becomes a practical problem on a significant scale once a market participant starts to operate across a number of states and finds itself having to reclassify customers according to different criteria and recalibrate applicable rules accordingly. There is greater clarity around the number of definitions that are provided for in SEC and CFTC regimes although, even here, opinions differ, driven probably by the different patterns of business undertaken by institutions. The position is also relatively straightforward in the UK as a result of the definitions of "market counterparty", "intermediate customer" and "private customer" applying across the investment spectrum. However, client classification in continental Europe is often more of an art than a science. Despite there being an overarching acceptance of the distinction between the wholesale and retail markets in these jurisdictions, a detailed analysis is required to be undertaken on a case-by-case basis to determine the perimeters of the wholesale and retail markets (and indeed whether any distinction is in fact drawn) for each and every piece of applicable legislation - unlike in the UK global client classification has not been adopted. Such differences emphasise how client classification definitions have evolved in a highly customised fashion, with each definition having its own national justification. In the new global trading environment, this multiplicity of definitions with its bespoke rationale looks increasingly less justifiable. In the view of the Participating Associations, this is an area where the regulatory authorities should give serious consideration to creating a much more coherent policy. However, despite the current complexities and lack of uniformity in this area, the implementation of MiFID in the EU is expected to make a significant contribution to EU convergence in respect of client classification.

³⁵ For a further legal analysis on client classification in the EU/US see section 6 of Part A of Volume II. Please also refer to the Schedule to Volume II for a comparative analysis of client classifications in the UK, France, Spain, Germany and the US.

48. These definitions are an essential tool in determining the borderline between institutional investors/wholesale business and retail investors/retail business. Achieving some consistency across products and across jurisdictions would be one of the most meaningful steps that could be taken in the medium term to create a more coherent transatlantic marketplace. There is no doubt that the whole new account opening process and the compliance function could be substantially simplified, offering considerable savings for businesses operating on each side of the Atlantic (and therefore for underlying investors) if the regulatory authorities could agree a set of coherent, uniform definitions by which customers could be classified.
49. One area of definitions where the variety is astonishing is in connection with net worth requirements. In certain jurisdictions, if an investor has a particular net worth then it will be treated as a form of institutional investor in the regime that is defining the net worth requirement. In the context of SEC Rule 15a-6, customers are required to have assets in excess of \$100 million before they can be approached under an exemption relating to that rule. By way of contrast, the CFTC's rules concerning eligible swap participants set a net worth requirement of only \$10 million. On the other side of the Atlantic, yet another set of criteria are used to determine participants in the wholesale market. For example, in the UK a body corporate or partnership with net assets of at least £5 million (or its equivalent in any other currency at the relevant time) will be classified as an "intermediate" rather than "retail" customer. These figures bear no relation to the intrinsic nature of the product.

Defining a "US person"

50. Several market participants have commented on the almost infinite variation that can be attributed to the words "US Person". Some of the most regular uses of this term relate to primary markets activity and the issuance of securities that might be sold to some categories of US institutional investor pursuant to SEC Regulation S and Rule 144A. However, that is not the only area in which the term "US Person" is relevant. Sometimes, "US Person" is defined to mean someone resident in the US. Sometimes it means a person who is domiciled in the US but not necessarily resident there. There is also confusion as to the status of the US Person definition in the context of institutional investment funds. For example, it is common practice to have an onshore US fund for subscription by US based investors and an offshore fund which is made available to non-US investors. However, both funds are managed by the same entity which is often based inside the US and either registered with the SEC as an investment adviser or with the CFTC as a commodity trading adviser.
51. The same definitional problems exist in the nation states of the EU. However, the detail which has developed over a number of decades in US regulation, and the reality that getting things wrong may result in regulatory censure or securities litigation, has forced product providers including companies raising capital to be cautious, and to engage extensively with their legal advisers in order to ensure that the right formulation of "US Person" is used in a specific transaction.
52. The conclusion to be drawn from this anecdotal evidence is that greater clarity of understanding for market participants (both product providers and product purchasers) and a more coherent approach to the application of investor protection requirements would be achieved by ensuring uniform usage of terminology such as "US Person" and the use of uniform definitions of customer, client and counterparty.

Individual registration requirements³⁶

53. The SEC and the CFTC have longstanding individual registration requirements, which have to be observed as a precondition for conducting business as an employee of a registered broker dealer or futures commission merchant. The picture in the EU, however, is very mixed. The FSA in the UK operates an individual registration system for individuals who are engaged in "controlled functions". In many other EU countries (such as Germany and Spain), there is no requirement for individual registration, only for the regulated entity itself.
54. The SEC scheme for individual registration is, perhaps, the most extensive. There are stipulations in respect of the handling of US client orders outside the US and there are requirements for sales people located outside the US who seek to contact US clients. Particular qualifications are required for particular roles.
55. Some market participants consider the SEC rules to be a restriction on the potential growth of US institutional participation in non-US markets. The simple lack of suitably qualified personnel in an EU firm precludes the offering of non-US products directly to US institutional investors. What is not precluded is the sale of such products by suitably qualified sales people located in the US within a registered broker-dealer. However, routing that sort of business from where it is most likely to be located outside the US through an affiliate or third party that is registered as a broker-dealer inside the US is the sort of complexity that can put some patterns of business into the "too difficult" basket where they quickly become neglected.
56. If individual registration is a necessity for the transatlantic marketplace, then one registration should be enough. All relevant individuals in a particular jurisdiction should be registered with the securities/derivatives regulatory agency of that country. Such registration should suffice for all the countries within the EU-US dialogue that choose to require it. If that were achieved, a dialogue could be commenced around subjects such as top-up requirements to enable individuals to be accredited to conduct business with US based clients.
57. This is an area which deserves to be reviewed by regulatory authorities on both sides of the Atlantic. It is an illustration of how the failure to establish a consensual approach on an inter-jurisdictional basis can result in uneven standards and regulatory fragmentation. In this regard the July 2005 announcement by the US National Association of Securities Dealers, the New York Stock Exchange and the UK Securities and Investment Institute of their agreement to create a common transatlantic qualifications exam for capital markets professionals is to be applauded. If approved by the SEC and the FSA, by late 2006, the exam will allow market professionals to move with ease between the US and the UK (subject to completion of the applicable top-up exam to cover US or UK regulatory requirements as the case may be). The Participating Associations see this as a breakthrough first step in the move towards the recognition of single individual registration for the transatlantic marketplace.

³⁶ For a further legal analysis on the approved persons regime in the EU/US see section 9 of Part A of Volume II.

Distribution of Research

58. Distributing equities research is an integral part of soliciting equities business from institutional investors. The conflicts of interest faced by analysts – highly publicised by the dot.com boom - resulted in not just increased securities litigation and a higher level of enforcement cases by regulatory authorities, in particular by the SEC, but also a proliferation of new securities regulations governing the generation, distribution and labelling of research materials in relation to equities. This latter development will, no doubt, prove to be the most enduring, but it has also proved to be surprisingly expensive for US financial institutions in terms of administrative time, management time and external advisory costs.
59. Unlike in the US, EU regulatory activism in relation to research applies not only to equities, but, through MAD³⁷, to fixed income instruments and related derivatives. Based on previous experience (such as the implementation of the Investment Services Directive), implementation of MAD in EU Member States will see the emergence of a new approach which might increasingly become differentiated as individual Member States add to the original pan-EU requirements generating overlapping regulation (sometimes with extraterritorial effect), greater legal uncertainty and higher regulatory risk.
60. The scope for specific regulatory activism in this domain is almost unlimited. The German securities regulator, BaFin, has recently introduced a notification requirement for any organisation, wherever based, which originates equities research which is then distributed in Germany. The notification obligation arises irrespective of whether the originator of the material is its distributor or whether an affiliate or third party is engaging in the distribution into Germany. It is unclear what purpose is served by this kind of notification requirement. It seems unlikely that it would permit BaFin to assert German jurisdiction over an entity that has no place of business in Germany and is not directly engaging in research distribution into Germany.
61. As a long term objective, regulators who are prepared to commit to making the transatlantic dialogue a greater success than it has been to date will have to return to topics such as research with a view to creating a set of regulatory arrangements that are tough on conflicts but are consistent in their application, scope, prescribed requirements and cost of administration.

³⁷ For a further legal analysis on the implementation of MAD in the EU see section 1.2 of Part A of Volume II. For a further legal analysis on market abuse/insider dealing in the EU/US see section 7 of Part A of Volume II.

Other conduct of business issues

62. A panoply of other aspects of conducting business are worthy of scrutiny by the private sector and by regulators in order to achieve simplification of existing requirements, recognition of the cross-border elements of conducting business and the eventual convergence of the materially onerous aspects of these requirements. Best execution, allocation policies, some parts of transaction documentation, electronic order routing and remote clearing and settlement management are all worthwhile candidates for this process of examination, constructive criticism and eventual amendment.

Client assets³⁸

63. Segregation of clients' assets and, in particular, cash (and the right to opt-out of segregation, where appropriate) is not a universally agreed concept in the EU, let alone as between the EU and the US. This is unfortunate as the CFTC and SEC have broadly similar approaches to the need to ensure that such assets are fully protected against financial institution insolvency or other default. Segregation of customer cash from the firm's own cash is a concept that applies to non-bank investment firms on both sides of the Atlantic. However, in the EU, banks can provide broker-dealer services in equities and client assets, including money, are treated as being received in the course of banking business and are not therefore segregated from other funds held by banks, including their own funds. This privileged position for EU banks is not easily accepted in the US, where broker-dealers cannot carry on business as banks (at least within the same legal entity).
64. Apart from the disparity in the powers of banks to conduct broker-dealer services in equities, the main consideration is the different views of what comprises segregation within the EU and, where it is applicable, what types of counterparties and customers can opt-out of segregation. For some, segregation is an accounting concept which may, or may not, survive liquidation of the licensed firm. In the UK, with its trust law, it has been natural to use trust mechanisms to provide customers with more certain protection that will extend into the firm's bankruptcy, so that the segregated assets will not form part of the firm's property, but must be held for the benefit of those of the firm's customers who have utilised segregation.

³⁸ For a further legal analysis on client assets and client money in the EU/US see section 13 of Part A of Volume II.

65. One consequence of the transatlantic split over acceptable forms of segregation is that the CFTC has insisted on money being put to one side by a CFTC-registered futures commission merchant to match the sum of the obligations owed in a non-US market on behalf of customers, unless the broker in the foreign market with which the futures commission merchant first deposits customer funds acknowledges that the funds are customer funds and will be held in accordance with the CFTC's regulations. The thinking behind this requirement is to ensure that client money is not exposed to credit risks in foreign markets.

Anti-money laundering (AML) procedures³⁹

66. AML procedures, taking the transatlantic marketplace in the round, are a complex mix of inconsistent requirements and arrangements that have evolved separately and with different objectives in mind over time. After 9/11, the importance attached to pre-9/11 AML statutory provisions in the US was redoubled. Efforts in Europe dated back to the late 1980s and resulted in the gradual building of an infrastructure to support laws that required financial institutions to verify client identity and report suspicious transactions with a broad-based, sometimes unspecific, approach to the nature of the activity to be prevented (narcotics are one thing but tax evasion (if it is not simply tax avoidance) is quite another). Following 9/11, the US (and other countries) acted quickly and unilaterally to bolster their respective legal frameworks specifically to combat terrorist financing.
67. However, the real complexities that have confronted financial institutions are the disparate approaches to interpretation and enforcement of AML provisions on both sides of the Atlantic. Whilst the AML rules that apply to different sectors of financial services in the US are the same and AML rules that apply in the EU are derived from common EU directives, there are variations in their enforcement by different regulators.
68. Whatever the aspect of AML procedures, differences of interpretation and enforcement can be found. There is no clear agreement between EU and US approaches as to what should be regarded as a "client relationship", yet it is the decisive factor in determining which entity or entities have to go through customer identification and other due diligence procedures. Relationships that are introduced by other financial institutions are particularly prone to uncertainty and ambiguity in this area and result in unnecessary duplication in the process of verifying identity. This is true whether business is being introduced from the EU to the US or vice versa. Participating in syndicated business that is originated in the US can be problematic for EU institutions.

³⁹ For a further legal analysis on anti-money laundering procedures in the EU/US see section 12 of Part A of Volume II.

69. This uncertainty affects affiliates as much as third party introducers. It is a bone of some contention with both service providers and customers that the EU arms of global financial institutions insist on undertaking EU-style AML diligence, even though a US affiliate has complied with US AML provisions (and vice versa). The lack of an integrated process may lead to behavioural arbitrage. If an EU firm cannot open an account for a client of its US affiliate the difficulty may be easily resolved by booking customer transactions to the account with the US affiliate and having a back-to-back transaction between the US entity and the EU entity. To make that particular arbitrage even more attractive, some AML provisions in the US contain "timing allowances" that are not available in most EU jurisdictions. Timing allowances allow accounts to be opened for clients before AML procedures have been completed.
70. The differences, both in terms of legislative objective and at a technical operational level, between US and EU AML provisions, their interpretation and enforcement needs to be reviewed and smoothed out.

Appendix 1

**C L I F F O R D
C H A N C E**

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DATE

17 March 2005

Member Firms of The Participating Associations

Dear Sirs/Madams

EU-US Regulatory Comparison Project: request for views relating to transatlantic capital markets regulation to be provided on confidential terms to Clifford Chance LLP

The financial services business associations listed below ("**Participating Associations**") are supporting a new initiative, which they refer to as the EU-US Regulatory Comparison Project (the "**Project**"):

American Bankers Association Securities Association ("**ABASA**")

Bankers' Association for Finance and Trade ("**BAFT**")⁴⁰

British Bankers' Association ("**BBA**")

Futures Industry Association ("**FIA**")

Futures and Options Association ("**FOA**")

Securities Industry Association ("**SIA**").

The Project is an innovative private sector study to compare and contrast EU and US business conduct and other related rules governing the carrying on of cross-border business in wholesale equities and related equity derivatives markets. An outline of this project and a timetable for its completion is attached. The Participating Associations, working with Clifford Chance LLP ("**Clifford Chance**"), intend, in this way, to establish a business-focused agenda for regulatory change for the Transatlantic Dialogue in financial services.

In order to ensure that this agenda properly reflects the spectrum of substantive regulatory challenges faced by firms in conducting cross-border business between the EU and the US, the Participating Associations need to conduct a confidential survey of their Member Firms.

⁴⁰ ABASA and BAFT are affiliates of the American Bankers Association.

Role of Clifford Chance

As you will note from the attached outline, Clifford Chance have been retained by the Participating Associations to undertake a legal review of a selection of rules and regulations in the EU and the US which are relevant to the purposes of the Project. The Participating Associations have instructed Clifford Chance to conduct this process of seeking information from Member Firms on their behalf.

The Participating Associations wish to facilitate frank and open disclosure by Member Firms of the substantive regulatory challenges faced by them in conducting their transatlantic business, but also recognise the vital need to preserve commercial confidentiality. For this reason, it has been agreed with Clifford Chance that all information provided by a Member Firm whether in writing or orally (see below) will be provided directly to one of their representatives.

Confidentiality of your response

Clifford Chance will not reveal to the Participating Associations or any other third party the identity of a contributor to this request for information in the context of any information provided by that contributor. The Project report will contain no references to Member Firms. Clifford Chance may use the information that is disclosed in the context of assisting Participating Associations to write the Project report, but no material will be used in a manner that could identify the source of the material. If information cannot be used in a manner that does not disclose its source, that information will not be used in the Project report or for any other purpose. It is the intention of the Participating Associations, together with Clifford Chance, to receive and process all information in a manner which will provide contributors with the greatest assurance of their identity remaining confidential.

Request for information in the following areas

You are asked to consider the following areas that are relevant to secondary market business in equities and exchange-traded and OTC equity derivative contracts:

Entity registrations and licensing issues

Do you find that licensing criteria or the scope of jurisdiction exercised by some regulators to be an impediment to the operation of a global business? If so, please describe how.

Are there any other cross-border entity registration and licensing issues that pose problems for your organisation?

Classification of customers and client documentation

How many definitions of customer/client/counterparty do you think you are taking into account in running your (i) EU business (ii) US business?

Do you find some of these definitions to be (a) compatible with one another and/or, (b) burdensome?

Are the definitions sufficiently clear in their meanings?

Are you able to draw a clear dividing line between wholesale and retail clients in these business areas across all of the EU and the US?

Are there any other customer classification or client documentation issues that pose problems for your institution?

Solicitation rules/financial promotions material

If you do use a global standard for compliance in this area, on which entity ("ies") laws/regulations is/are your compliance programme based? In which countries do you have a "top-up" provision to ensure compliance with local (perhaps atypical) requirements?

What do you see as the impediments to operating a single standard globally? If possible, please give examples.

Are there any other solicitation/financial promotion materials that pose problems for your organisations?

Anti-money Laundering Rules

Please indicate what problems you have encountered in the area of anti-money laundering provisions.

The topics outlined above as part of this request for information are not intended to be exhaustive. If there are any other particular matters that you wish to share on the confidential basis described above, please do inform Clifford Chance accordingly.

Written responses

If you are responding in writing, please e-mail your response marked "EU-US Regulatory Comparison Project" as follows: tim.plews@cliffordchance.com.

Oral Responses

If you would rather speak to an individual at Clifford Chance please do not hesitate to contact any of the following:

Name	Office	Telephone Number
Tim Plews	London	+44 207 006 1411
John Ketels	Washington DC	+1 202 912 5097
Steve Gatti	Washington DC	+1 202 912 5095
Marc Benzler	Frankfurt	+49 69 7199 3304
Jose Manuel Cuenca	Madrid	+34 91 590 7535
David Yeres	New York	+1 212 878 8075
Richard Coffman	New York	+1 212 878 8071

Deadline for Responses

The Participating Associations and Clifford Chance appreciate that the staff of Member Firms are very busy. However, they do encourage you to respond as quickly as possible to this request for information. They would like to receive your responses by close of business on Friday, 8 April 2005.

Yours faithfully

Clifford Chance Limited Liability Partnership

Appendix II

Important note concerning the status of the information in Appendix II

The information in this Appendix reflects the views of and advice given to clients by professional legal advisers in different EU member states concerning market access for non-EU entities engaged in equity broking. The Participating Associations express no view on this information.

The information in this Appendix relates to equities, rather than equity derivatives (whether exchange-traded or over the counter derivatives). In some jurisdictions the treatment of derivatives differs substantially from the treatment of equities. The information in this Appendix is intended to illustrate a variety of approaches which are adopted by national regulatory agencies across the EU in the context of US firms seeking to do business in these EU jurisdictions. The following assumptions apply to what follows:

- the business undertaken is that of brokerage services relating to equities (and not equity derivatives);
- all services are provided on a "pure" cross-border basis (i.e. the US firm has no permanent establishment or presence in the relevant jurisdiction);
- all services are carried on from the US (unless an EEA passported entity is used by way of intermediary);
- only institutional investors are being targeted in each jurisdiction (and only limited numbers of them); and
- there will be no public marketing campaign nor frequent visits to the relevant jurisdiction.

The reference to making use of an EEA passported entity by way of intermediary raises the concept of "intermediation". Relevant EU directives have nothing to say about intermediation. Intermediation is a construction which has evolved out of practice that pre-dates the relevant EU directives and which has been, broadly speaking, approved of by relevant legal and compliance advisors. Intermediation means an arrangement where an EEA passported entity acts as an intermediary between a US firm (which is not locally licensed) and institutional investors in the relevant jurisdiction (i.e. the EEA passported entity performs all client-facing functions but the US firm will be the contractual counterparty). This is sometimes referred to as "soft" intermediation. There is also "hard" intermediation which entails the EEA passported entity being the contractual counterparty of the institutional investor. The EEA passported entity will, in turn, enter into a back-to-back or matching transaction with the US firm so that it maintains a "flat" position or, as it is sometimes referred to, acts as a riskless principal.

There are four broadly discernible approaches adopted by national regulatory agencies across the EU:

1. cross-border business with institutional investors does not trigger a licensing requirement;
2. the position as to licensing is either not clear or, secondly, a licence is required in order to do cross-border business but that requirement is not unduly onerous;
3. a licence is needed to do cross-border business but soft intermediation may be a solution; and
4. a licence is required to do cross-border business and soft intermediation is not regarded as a solution.

Approach 1

In jurisdictions following approach 1 it is possible for US firms to avoid triggering licensing requirements by taking advantage of safe harbours which apply when business is carried out on a cross-border basis with corporate entities. In other jurisdictions, licensing requirements will not apply to US firms where cross-border business is conducted purely with institutional investors.

Approach 2

It is unclear in certain jurisdictions following approach 2 whether a licence is required for US firms carrying out cross-border business (for example, where regulators have taken action against unlicensed entities soliciting retail investors but where no such action has been taken in relation to institutional investors). In other jurisdictions a licence is required for cross-border business carried out by US firms, but such a requirement is not onerous (for example, a simple notification has to be made to the relevant regulator (which does not require approval from the regulator) to carry out business on a cross-border basis with institutional investors). Alternatively, a licence may not be required for jurisdictions in which US firms only conduct business occasionally and with a restricted number of investors. Soft intermediation may work for certain jurisdictions following approach 2.

Approach 3

Certain jurisdictions following approach 3 require US firms to be licensed where their services are "provided in" the jurisdiction in question. However, it is not always clear as to when services will be deemed to be "provided in" a particular jurisdiction. Other jurisdictions require US firms engaging in cross-border business, where services are to be provided in the jurisdiction in question, to be licensed through the creation of a permanent establishment in that jurisdiction. However, soft intermediation may work for certain jurisdictions adopting approach 3.

Approach 4

In jurisdictions following approach 4, US firms will need to be locally licensed. The process for obtaining licences in such jurisdictions is often onerous and lengthy and there are usually no exemptions to the licensing requirements, although occasionally hard intermediation will work. Soft intermediation is generally not considered as working in jurisdictions following approach 4.

Appendix III

The Participating Associations are:-

The ABA Securities Association (ABASA) is a separately chartered trade association and non-profit affiliate of the American Bankers Association whose mission is to represent the interests of banks underwriting and dealing in securities, proprietary mutual funds and derivatives before Congress, federal and state governments, and the courts.

The Bankers' Association for Finance and Trade (BAFT) was founded in 1921 to promote the establishment of uniform systems and methods for the conduct of foreign business and to aid the development and maintenance of foreign trade. Today, BAFT is an affiliate of the American Bankers Association and has more than 180 members that are active in a wide variety of international wholesale and retail banking activities, including trade finance, correspondent banking, global capital markets, global custody, and global payments. Its mission continues to be addressing the concerns of bankers who are engaged in international business activities.

The British Bankers' Association (BBA) is the leading trade association in the banking and financial services industry representing banks and other financial services firms operating in the UK. It has 250 members, three quarters of whom are of non-UK origin, representing 60 different countries. BBA members hold 90% of the UK banking sector's assets and represent 95% of all banking employment in the UK. Given its international membership and location in the world's leading financial centre, the BBA covers a wide variety of UK, European and international issues.

The Futures Industry Association (FIA) is a principal spokesman for the commodity futures and options industry. Its regular membership is comprised of approximately 40 of the largest futures commission merchants in the US. Among its approximately 150 associate members are representatives of virtually all other segments of the futures industry, both national and international, including US and international exchanges, banks, legal and accounting firms, introducing brokers, commodity trading advisors, commodity pool operators and other market participants, and information and equipment providers. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than 90% of all customer transactions executed on US contract markets.

The Futures and Options Association (FOA) is the industry association for some 160 international firms and institutions which engage in the carrying on of derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, fund managers and firms involved in supplying services into the futures and options sector. Further details are available on our website, www.foa.co.uk.

The Securities Industry Association (SIA) brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all US and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the US securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated \$236.7 billion in domestic revenue and an estimated \$340 billion in global revenues.

American Bankers Association Securities Association (ABASA) : www.aba.com

Bankers' Association for Finance and Trade (BAFT) : www.baft.org

British Bankers' Association (BBA) : www.bba.org.uk

Futures Industry Association (FIA) : www.futuresindustry.org

Futures and Options Association (FOA) : www.foa.co.uk

Securities Industry Association (SIA) : www.sia.com

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